



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Yellow file

Date:

JAN 14 2002

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

According to your Form 1023 Application, you were organized on [REDACTED] as a [REDACTED] nonprofit corporation. Your "Amended Articles of Incorporation" on file fail to specify how your assets will be distributed upon dissolution.

You provide consulting services (e.g., strategic planning, training, and staffing studies) for a fee to various State and local government agency clients to promote more efficient operations. You also use information from these activities to prepare scholarly articles, newsletters, and an annual report. The newsletters and reports are provided free to all interested parties and will be available on your Web site.

You claim that your fees (based on competitive bids, currently about \$[REDACTED]/hour) are substantially lower than those of for-profit companies providing similar services. You compete on the open market for your services with private for-profit consulting firms and various nonprofit organizations to earn contract awards and occasionally grants. The grants require you to provide specific consulting services like those provided under the contracts. Some government agencies recently have required that all bidders be nonprofit organizations.

Your self-perpetuating board of three directors comprises [REDACTED], [REDACTED], and a member of the [REDACTED]. [REDACTED] are also your officers.

Most of your services are contracted out to [REDACTED]

██████████ is a for-profit corporation owned and operated by the ██████████. As a corporation (and previously as a sole proprietorship of ██████████), ██████████ has provided various consulting services to government agencies for over ██████████ years, including strategic planning and organizational change; instructional systems and video training cases; training and facilitation; and technical management assistance.

Nearly all of your past and projected support is gross receipts from business. You also project a nominal amount of contributions by soliciting the public. Your past and projected budgets show profits well in excess of contributions received.

Section 501(c)(3) of the Internal Revenue Code exempts from federal income tax organizations organized and operated exclusively for charitable, educational, or certain other purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(c) of the Income Tax Regulations states that the words "private shareholder or individual" refer to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(a)(4) of the regulations provides that an organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets will be considered dedicated to an exempt purpose, for example, if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal Government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized. However, an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization "operates exclusively" for 501(c)(3) purposes only if it engages primarily in activities that accomplish such purposes. It does not operate exclusively for 501(c)(3) purposes if more than an insubstantial part of its activities does not further such purposes.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for exempt purposes under section 501(c)(3) of the Code unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations defines "charitable" as including lessening the burdens of Government.

Rev. Rul. 72-369, 1972-2 C.B. 245, held that a nonprofit organization formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations to improve the administration of their charitable programs did not qualify for exemption under section 501(c)(3) of the Code. The organization entered into agreements with unrelated nonprofit organizations to furnish managerial and consulting services on a cost basis. The services consisted of writing job descriptions and training manuals, recruiting personnel, constructing organizational charts, and advising organizations on specific methods of operation. The activities were designed for the individual needs of each client organization. Receipts of the organization were from services rendered. Disbursements were for operating expenses. The Service reasoned that providing managerial and consulting services on a regular basis for a fee is trade or business ordinarily carried on for profit. The fact that the services were provided at cost and solely for exempt organizations was not sufficient to characterize this activity as charitable under section 501(c)(3). Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable. This case was distinguished from Rev. Rul. 71-529, 1971-2 C.B. 234, where an organization controlled by a group of exempt organizations provided investment management services for a charge substantially less than cost (less than 15% of cost) solely to that group.

Rev. Rul. 74-125, 1974-1 C.B. 327, held that a private foundation's payments to consultants were not grants under section 4945(d)(3) of the Code. The foundation's activities included disseminating publications and developing and conducting training programs to assist educators in using improved educational methods. The consultants' services included the development of model curricula in a particular educational area and the design of materials to assist educators in the performance of their educational functions. The Service reasoned that the consultants' services were personal services assisting the foundation in planning and developing its projects under section 53.4945-4(a)(2) of the regulations.

In Better Business Bureau v. United States, 316 U.S. 279 (1945), the Supreme Court considered the meaning of "organized and operated exclusively for charitable purposes." The Court held that the existence of a single non-exempt purpose, if substantial in nature, will destroy the exemption.

In American Institute for Economic Research v. United States, 157 Ct.Cl. 548, 555, 302 F.2d 934, 937-38 (1962), cert. denied, 372 U.S. 976 (1963), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code. The organization was founded by an individual who was director, cotrustee, and life member, and who received a salary. The organization's stated purposes were to conduct scientific research in economics and disseminate the results to educate the public in economics. The organization published two periodicals which contained brief analyses of industries and individual securities. Subscribers were entitled to a quarterly list of securities recommended by the organization. The organization provided various investment advisory services for a fee. The organization also trained students in economics, but this activity was relatively small in scale with intermittent interruptions. The court reasoned that the organization's exempt purposes were incidental to its primary purpose to conduct business. The court noted that even though the organization's activities may have been educational, the organization had profits, that the organization's services were commonly associated with commercial enterprises, and the organization received

no bona fide charitable contributions, which indicated a substantial nonexempt purpose.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code. The court considered such factors as the particular manner in which the organization's activities were conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits as relevant evidence of the organization's predominant purpose to conduct a business. The organization's sole planned activity was to offer consulting services for a fee to nonprofit organizations having limited resources (some of which were exempt organizations) and engaged in various rural-related activities. The organization's goals were to help its clients deal with problems they face regarding the external environments within which they operate, change their priorities, implement realistic internal planning and management policies, and improve their understanding of governmental policy processes and methods for becoming more effective in their work through public and private funding. The organization obtained appropriate individuals to perform research projects for the clients. The organization did not advertise its services. The organization's officers planned for the first few years to serve without compensation. The fees charged by the organization were set at or close to cost and were to some extent based on the client's ability to pay, but as a whole were intended to cover its costs. The organization projected a net profit in its first year of operation. The organization failed to show that it was not in competition with commercial enterprises, which the court considered strong evidence of the predominance of a nonexempt commercial purpose. The court contrasted the case to one where an organization, concededly conducting substantial educational, scientific, or charitable activities, also conducts a trade or business related to its exempt functions. The organization's activity of linking researchers with client organizations was not inherently charitable, and the organization failed to show that such research would further exclusively exempt purposes. The organization's sole source of support was fees for services. The organization's clientele was not limited to section 501(c)(3) organizations.

In Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code. The organization was organized to operate a pharmacy to sell drugs at discount prices to elderly and handicapped persons. It had no commitment to use excess receipts to provide drugs for free or below cost to the elderly or handicapped. The organization served elderly and handicapped people almost exclusively, and did not sell toiletry articles, magazines, cards, or other items normally sold for profit by pharmacies. The organization's board consisted of community leaders, none of whom obtained any personal financial benefit from participation. The organization used the services of volunteers (for mailing prescriptions, completing patient profiles, maintenance, etc.) instead of paid employees. All gifts were used for the benefit of financially distressed senior citizens who, because of a catastrophic illness or accident, incurred large prescription drug bills. The court reasoned that the organization operated its business primarily for commercial purposes, in competition with profitmaking drug stores. The mere fact that products sold by the organization were helpful to health did not necessarily entitle it to exemption under section 501(c)(3).

In Christian Manner International, Inc. v. Commissioner, 71 T.C. 661 (1979), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code where the

organization's primary activity was the publication and sale of books written by its founder which were religiously inspired and oriented but were sold commercially at a profit, its other planned religious activities were not specifically planned out and were not yet put into effect, and its publication and sale activities competed with other businesses which marketed religious literature. The organization's sources of support were book sales and contributions, but many of the "contributions" were made in exchange for a book for a minimum contribution exceeding the list price of the book.

In Senior Citizens Stores, Inc. v. United States, 602 F.2d 711 (5th Cir. 1979), the court upheld the Commissioner's determination that the organization's retail sales operation was an end in itself rather than merely a means of accomplishing a charitable goal, and therefore the organization was not devoted exclusively to charitable purposes. The organization's stated purpose was to provide training, jobs, places of recreation, and living accommodations, and to improve the physical and mental conditions of aged or senior citizens. The organization engaged in the business of selling used clothing, furniture, and household appliances which were donated to the organization by the general public. Its affairs were run by a board of three directors, two of whom were father and son. The organization reported net income. Although half of the organization's 13 employees were over 55, their training was restricted to the needs of plaintiff's business, and the organization conducted no training program beyond the training of employees for its own shops. The organization did not provide any housing facilities or health care. 10% or less of the donated items were distributed directly to needy senior citizens, although no complete records were kept of such distributions and the organization apparently conducted no advertising to let senior citizens know of the availability of such items. There was no evidence that senior citizens received a discount on purchases from the stores. The organization maintained a recreation hall above one of its three stores. The only evidence of business proceeds devoted to the recreation hall was a \$160 monthly salary paid to its part-time director. The court concluded that the business was not distinguishable from that of many typical family-operated businesses in which the excess of income over expenses is paid to various family members as rents or salaries.

In est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), aff'd by unpublished opinion, 647 F.2d 170 (9th Cir. 1981), a nonprofit organization paid a for-profit organization for licenses to conduct "est" programs involving training, seminars, and lectures in intrapersonal awareness and communication. The court ruled that the nonprofit's activities served the commercial purposes of the for-profit corporations and thus the nonprofit was not operated exclusively for exempt purposes under section 501(c)(3) of the Code. Even though the nonprofit was not formally controlled by the same individuals as the for-profits, the for-profits exerted considerable control over the nonprofit's activities through the licensing agreements. The nonprofit's only function was to sell to the public ideas with materials and trainers supplied and controlled by the for-profits. Regardless of whether the payments from the nonprofit to the for-profits were excessive, the for-profits benefitted substantially from the nonprofit's operation. The nonprofit was simply the instrument to subsidize the for-profits and not vice-versa and had no life independent of the for-profits.

In P.L.L. Scholarship Fund v. Commissioner, 82 T.C. 196 (1984), a nonprofit organization's regularly scheduled bingo games were held on the premises of a for-profit

business which sold food and beverages, the games were conducted by the owners of the for-profit, and the directors of the for-profit controlled the nonprofit's board. Under these circumstances, the court held that the nonprofit had a substantial non-exempt purpose to enhance the profits of the for-profit.

In Church by Mail, Inc. v. Commissioner, 765 F.2d 1387 (9th Cir. 1985), the court upheld denial of 501(c)(3) status to a church operated for the substantial non-exempt purpose of providing a market for the services of a for-profit advertising agency owned and controlled by its two ministers. The church's primary activity was preparing and mailing religious sermons and messages which included requests for money. The for-profit did the printing and mailing. The two organizations shared office space. The church provided the primary market for the for-profit's business, with two-thirds of the time of the for-profit's employees devoted to work for the church. The majority of the church's income was paid to the for-profit. The court noted that the critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable, but instead whether the entire enterprise is carried on in such a manner that the for-profit benefits substantially from the operation of the nonprofit.

In International Postgraduate Medical Foundation v. Commissioner, T.C. Memo 1989-36 (1989), the court upheld revocation of 501(c)(3) exemption of a nonprofit organization that conducted continuing medical education tours abroad. The nonprofit had a substantial non-exempt purpose to benefit a for-profit travel agency which the nonprofit used exclusively to arrange tours for its seminars. The nonprofit spent 90% of its revenue on brochures for tours arranged by the for-profit and did not solicit competitive bids from any other travel agency. The nonprofit was formed by the owner of the for-profit to obtain customers for his tour business, he controlled the nonprofit, and he exercised that control for the benefit of the for-profit. The court noted that when a for-profit benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes under section 501(c)(3), even if it furthers other exempt purposes.

In Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code to an organization formed primarily to operate vegetarian health food restaurants and stores on the ground that the organization had a substantial commercial purpose. The court considered the particular manner in which an organization's activities were conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of annual or accumulated profits as relevant evidence in determining whether the organization had a substantial nonexempt purpose. The organization at issue competed with other restaurants, set its hours and prices competitively with area businesses using pricing formulas common in the retail food business, spent substantial sums in advertising which was commercial in style, was unable to show any donations of food to the poor, and had substantial gross profits (although no net profits) during the years at issue (its first two years).

In KJ's Fund Raisers, Inc. v. Commissioner, T.C.M. 1997-424, affirmed by unpublished opinion, 98-2 U.S.T.C. 50,869 (2d Cir. 1998), a nonprofit organization regularly sold lottery tickets on the premises of a for-profit business which sold beverages, and the ticket sales were conducted by the owners (Hurd and Gould) and employees of the for-profit. Hurd and Gould

initially controlled the nonprofit's board; the nonprofit later represented that control would be vested in outsiders, but opined that the nonprofit "would fold without the original founders of the organization as officers." In addition, the for-profit initially received rent from the nonprofit, and Hurd and Gould initially received wages as officers of the nonprofit. Under these circumstances, the court held that the nonprofit had a substantial non-exempt purpose to enhance the profits of the for-profit. The court reasoned in part that Hurd and Gould, even if they no longer formally controlled the nonprofit's board, controlled the ticket sales, and the circumstances suggested that they were free to set policy without objection from the board. The court also found that favorable publicity that the for-profit received from the nonprofit was a significant benefit.

We find that you are not "organized" for exempt purposes. Your articles of incorporation fail to meet the 501(c)(3) organizational test because they do not specify that your assets will be dedicated to exempt purposes upon dissolution. See section 1.501(c)(3)-1(a)(4) of the regulations.

We also find that you are not "operated" for exempt purposes, for two reasons: your operations are not charitable but commercial in nature, and they benefit private interests.

First, your provision of consulting services for a fee in competition with commercial entities is not charitable, but amounts to a substantial nonexempt purpose and a primary purpose to conduct unrelated business. The mere fact that you provide these services exclusively to government agencies at cost (as opposed to substantially below cost) is insufficient to render the activity as charitable. See Rev. Rul. 72-369. Although some of your competitively bid awards are labelled as grants rather than contracts, the substance of the agreements appears the same, requiring you to provide various consulting services in exchange for compensation. The courts also have held organizations providing commercial services for a fee not to qualify under section 501(c)(3), especially where the organization has profits and lacks substantial charitable contributions. See, e.g., American Institute for Economic Research; B.S.W. Group, Inc.; Federation Pharmacy Services, Inc.; Christian Manner International, Inc.; Senior Citizens Stores, Inc.; and Living Faith, Inc.

Second, even if your activities were regarded as furthering charitable purposes, you would not be operated "exclusively" for exempt purposes, as your operations benefit [REDACTED] and other private interests substantially. You were created and are controlled by [REDACTED]. You will contract with their business ([REDACTED]) for services. In so doing, you will increase their business and profits. Thus, you will serve as a valuable, captive source of business for them. There is no evidence that [REDACTED] will provide its services for a fee substantially below cost. These facts indicate to us that you were organized substantially for the purpose of benefitting [REDACTED] and their business by generating business for them. See, e.g., est of Hawaii; P.L.L. Scholarship Fund; Church by Mail, Inc.; International Postgraduate Medical Foundation; and KJ's Fund Raisers, Inc. Like the situations described in these cases, you are controlled by private interests, and the facts indicate that your operations will substantially benefit those private interests, thus resulting in a substantial nonexempt purpose.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service

1111 Constitution Ave, N.W.
Washington, D.C. 20224

[REDACTED]

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

(signed) [REDACTED]

[REDACTED]
Manager, Exempt Organizations
Technical Group 2

initialed

reviewer

[REDACTED]

1/14/01

[REDACTED]

1/14/01